

The New Variant and Market Volatility

BMO Private Wealth | December 2021

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Market volatility picked up significantly over the last week lead by two major developments: (1) the emergence of a new COVID virus variant – Omicron; and (2) U.S. Federal Reserve (“Fed”) Chairman Powell admitting that higher than target inflation should no longer be described as transitory, and it may have to further slow the pace of bond purchases.

On Black Friday, the world woke up to headlines about a new COVID variant called Omicron, which appears to originate from the Gauteng province of South Africa. What makes Omicron different is that it has 32 mutations on the spike protein, double that of the Delta variant, with some mutations never seen before. This new development is concerning for markets, but we need to realize that society is far better equipped to deal with this emerging threat than it was just a year ago. It is still too early to assess the transmissibility and severity of Omicron, but major manufacturers including Astra Zeneca, Johnson & Johnson, Moderna and Pfizer are already testing the efficacy of existing vaccines. As we get more clinical information adjustments may be required but Pfizer, with an annual capacity of 6 billion doses a year, has already stated that it can adapt the current vaccine within six weeks and ship initial batches within 100 days in the event of an escape variant. Moderna also confirmed that a new formulation could be ready in early 2022 if needed.

BMO Capital Markets hosted a call with an industry expert, Dr. Don Diamond, a Professor of Hematology and Hematopoietic Cell Transplantation, who stated his belief that Omicron was perceived as more transmissible but potentially less severe than prior variants. In his opinion the current vaccines and newer antivirals will continue to provide a good level of effectiveness which should make renewed global lockdowns unlikely with the exception of some European countries in the short term. In fact, expectations are that the virus could potentially morph to be more like the flu with severe side effects minimized by vaccines and antiviral drugs. That gives us a measure of comfort, particularly as we have

always thought that COVID vaccinations would become an annual (or biannual) event for the foreseeable future (similar to flu shots but far more critical), rather than a one to two shot deal.

As the economy continues to face supply chain issues and elevated inflation, the combination of a new strain with the prospect of the Fed reducing monetary stimulus is increasing market volatility. The current consensus is that inflation is set to come down significantly in the U.S. and Canada next year — to just over 2% — from multi-decade high levels (5-6% as measured by the Consumer Price Index). While supply chain improvements will help somewhat, and we may get some longer-term support from productivity improvements, we still think that in light of the recent developments this view maybe too optimistic. The U.S. Fed has a mandate to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates. The higher inflation and strong economic recovery will likely lead the Federal Reserve to speed up the tapering of its asset purchase program. The key reason behind tapering (removal of monetary stimulus) is that inflation expectations continue to rise for businesses and consumers, which results in households making purchases more quickly (i.e., buy today since tomorrow prices will be higher), and demanding higher wages (which the data shows unequivocally). We do not believe we are headed back to 1950s or 1970s hyper-inflation but the Bank of Canada and the Fed may well have to start raising rates sooner rather than later to contain this pressure. While rising inflation is bad news for most consumers, well positioned companies with pricing power can actually expand their profit margins in such an environment.

This year the North American markets have delivered very strong returns, with the S&P 500 up 23.2% and the S&P/TSX delivering a return of 21.4% as of the end of November. We continue to be very bullish on equities. We also noted that “we believe some bearish analysts may be underestimating

the potential length of this economic cycle. The key reason for this is that there remains considerable pent up demand for leisure products, cars, electronics, technology solutions, etc. which should extend through 2022 and into 2023¹.

While multiple expansion was the key driver of market returns up to the middle of 2020, the baton has been passed on to earnings growth. Since mid-2020, corporate earnings have exploded upward at a historical pace. Insatiable demand for a number of goods has provided pricing power to a host of well-positioned companies and has driven up profit margins. More specifically, FactSet reported that for Q3 2021 the earnings growth rate is close to 40%, which is well above the 5-year average earnings growth rate of 11.8% and just shy of the Q2 2010 record. The Financials, Health Care, Information Technology and Energy sectors have been the largest contributors to the increase in the earnings growth rate for the index since September 30, with Financials seeing the largest increase in earnings and Energy seeing the largest increase in revenue estimates. This trend fits nicely with our positive stance on both the Financials and Energy sectors which happen to be among the top performers when inflation has moved up historically, while still having very reasonable valuations. Given their significant weight in the S&P/TSX (much higher than in the S&P 500) this also backs up our view that Canadian equities should outperform their U.S. counterparts for the next year at least.

Volatility has been exacerbated by hedge funds, which have significantly reduced their exposure with net leverage falling to one-year lows according to a study by Goldman Sachs¹. The move to risk-off may be more significant than otherwise may be the case as funds want to preserve what has been strong YTD performance, and execute year-end tax loss harvesting.

We strongly recommend against overreacting to the current bout of volatility. The key is to maintain a well-diversified portfolio including bonds, cash and high-quality stocks. Of course, market turbulence could continue for a while longer, so the key is to hold on and accumulate the right types of equities. Key characteristics include very high barriers to entry (a competitive advantage), strong balance sheets (low or no debt), and strong consistent dividend growth potential. History has shown that such companies tend to generate outsized profits over a long period of time, and they also act more defensively in tough environments such as the one we are experiencing right now.

As a reminder, it is always important to maintain a long-term perspective on your investment strategy. Please contact your BMO financial professional if you would like to discuss your investment portfolio.



Information from BMO Capital Markets and the BMO Nesbitt Burns Portfolio Advisory Team were used to produce this report.

¹ <https://www.bloomberg.com/news/articles/2021-12-01/hedge-funds-cut-leverage-to-year-low-as-costly-tech-slumps-aneu>

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